Bundesinitiative Impact Investing

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Position paper #03

Impact Due Diligence Principles

This paper outlines key principles vital for the impact due diligence [IDD] process in impact investing, as defined by the Bundesinitiative Impact Investing [BIII, 2022]. Unlike traditional investment strategies, impact investors perform both financial and IDD versions. Recent reports highlight such investors' growing emphasis on impact due diligence processes, not only for their intrinsic value, but also for their influence on investor ratings. Therefore, this document offers guidelines to facilitate effective IDD for a diverse range of impact investors. It aims to assist them in meeting their asset allocators' expectations and provides stakeholders with insights about what to anticipate during IDD processes. Ultimately, these principles are aimed at catalyzing a shift towards an impact-driven approach in the German investment market, aiding conventional investment firms in adopting impact-centric strategies. Additionally, the IDD Principles serve as a foundation to inspire collaboration among European stakeholders in the field, with the goal of establishing standardized and systematic IDD practices across Europe in the future.

The paper captures IDD as an essential process distinct from, yet intertwined with, general due diligence in the investment landscape.

Traditional due diligence is a comprehensive appraisal of a business or investment opportunity to assess its commercial, financial, and legal standing. In contrast, IDD evaluates the potential social and environmental impacts alongside these traditional metrics. The need for IDD is twofold: It aligns with investor duties of care, ensuring responsible and ethical investment practices, and adheres to the legal principle that IDD is mandatory for impact investors. An impact investor carries out IDD to assess a potential investment's [an asset impact's] direct social and environmental effects as well as its contribution to their portfolio's overall impact. In addition, they assess its role in, and potential contribution to, the development of a potential investment's impact, conducting this process with an emphasis on equal footing and close collaboration.

The IDD Principles developed in this paper are built on the foundation of existing laws and regulations, ensuring alignment with institutional investors' obligations. They not only adhere to current mandates such as Environmental, Social, and Governance [ESG] aspects, the Corporate Sustainability Reporting Directive [CSRD], and the Sustainable Finance Disclosure Regulation [SFDR], but extend beyond these new standards' requirements.

For example, the IDD Principles also incorporate aspects of double materiality, which considers both the business model's external impact and the reciprocal effect of external factor working on it. Yet they go beyond standard obligations by aiming for a greater context, more in-depth impact analysis, and greater consistencies in impact measurement and management processes. Thus, although each impact investor may not, at present, consistently implement each IDD Principle as such, their goal is to establish IDD as a valuable and practical approach, aimed at driving substantial real-world impact by the sector.

These IDD Principles were developed through a multi-stage process, ensuring their relevance and effectiveness for the German impact investing market. To derive the first version of the principles, the paper's authors conducted an extensive review of existing scientific research, IDD reports and statements—including international frameworks provided by organizations like BlueMark, Global Impact Investing Network [GIIN], Impact Frontiers, and Pacific Community Ventures [PCV].

This review was designed to identify how these existing resources align with the German market's needs and to highlight where the principles can close current gaps. The preliminary set of IDD principles was refined through a two-step peer-review process. In the first stage, detailed feedback was solicited from a panel of German impact investing experts with international experience in the field. After integrating the panel's suggestions, a personal meeting was organized to discuss implementing the experts' feedback. In the second stage, the review was expanded to include all members of the BII's working group on impact measurement and management. The revised principles were presented at a digital event where additional insights were gathered from practitioners, including impact investors and impact startup representatives with experience in IDD processes. The following IDD Principles therefore represent the first milestone of this meticulous, stepwise approach, tailored specifically to the German impact investing sector. Collated with pragmatism, the IDD Principles in this paper are characterized by their equal importance and interconnectedness, thus forming a coherent framework.

IMPACT DUE DILIGENCE PRINCIPLES

#1: Strategy

#2: Team involvement

#3: Ecosystem involvement

#4: Net-positivity

#5: Impact assessment

#6: Time frame

#7: Impact risks

#8: Exit planning

#9: Impact management

#10: Transparency

IDD Principle 1
Strategy:
IDD roots in the investment strategy of impact investors.

This principle underscores that an impact investor must comprehensively integrate IDD within their investment strategies. Such integration involves conducting extensive evaluations, planning the impact management, and reporting social as well as environmental outcomes. The investor executes IDD for each potential investment and assesses how individual investments collectively contribute to their overall portfolio and impact objectives. The key components of this approach include understanding baseline metrics and target impact contributions in specific impact areas, as well as establishing specific impact Key Performance Indicators [KPIs] and milestones for both individual investments and the portfolio as a whole. An impact investor utilizing this embedded strategy approach will demonstrate a deliberate and clear intentional focus, resulting in an implemented theory of change for both individual investments and the investor's overall impact objectives.[1]

Additionally, IDD is deeply anchored in established theoretical or normative frameworks to provide a robust, ethical, and principled foundation for assessing impacts and guiding decision-making. Such grounding enhances its credibility and rigor by aligning it with well-founded theories or widely recognized norms. This alignment is crucial for clarifying an investor's specific impact objectives; it facilitates clearer communication and understanding among stakeholders as well as fosters trust. Rooting IDD in such frameworks also empowers investors to more effectively articulate, evaluate, and fulfill their social and environmental goals. Ideally, impact investors align their investment strategies with global political frameworks like the Sustainable Development Goals [SDGs] or the Universal Declaration of Human Rights, or scientifically established concepts such as planetary boundaries or the Doughnut Economy model.

IDD Principle 2
Team involvement:
IDD involves multiple levels of an impact investing organization.

IDD requires the active involvement and collaboration of multiple levels across an organization, ensuring a unified and comprehensive approach to impact assessment and investment decision-making. The processes are therefore deeply interwoven into the organizational structure and not isolated in one place. Each impact investing organization faces unique challenges in integrating different teams into the IDD process, necessitating tailored strategies. Clearly defining roles and responsibilities for each staff member involved in the IDD process is crucial, as it fosters systematic and structured collaboration across teams. This not only embeds IDD in impact investors' core operations, but also ensures that every organizational level is aligned with and knowledgeable about its impact mission. Emphasizing continuous training and open communication channels can further enhance understanding and effectiveness in implementing IDD.

1. For further information on the intended effect and aspects of the theory of change, please refer to: www.bundesinitiative-impact-investing.de/wp-content/uploads/2023/08/2301113_BIII_PP1_final.pdf

IDD Principle 3
Ecosystem involvement:
IDD adapts to, integrates, and incorporates the multi-faceted aspects of its external environment.

IDD comprehensively acknowledges and integrates the distinct environmental, social, cultural, economic, and institutional elements specific to the community or area of investment. This approach entails that impact investors are deeply committed to thoroughly understanding the local nuances and requirements of their targeted impact regions. Where possible, they undertake essential steps — like engaging directly with external stakeholders such as beneficiaries or environmental experts — to gain this understanding. Such depth in comprehension ensures that the investment strategy aligns with the needs and expectations of relevant stakeholders and environmental requirements; it is vital to circumvent adverse outcomes witnessed in past instances, where a lack of local insight prevented well-meaning initiatives from yielding beneficial results. Furthermore, this principle mandates the inclusion of ESG considerations, ensuring investments do not detrimentally impact vulnerable groups. Finally, engaging stakeholders from the planning phase enhances their sense of investment ownership and commitment. This underlines the importance of making the IDD process as participatory as possible. The 2023 Global Impact Investing Network [GIIN] report highlights the increasing recognition and implementation of stakeholder engagement in impact investing globally, showcasing its importance in developing impactful and accountable investment practices.

IDD Principle 4
Net-positivity:
IDD captures the expected net positive impact.

IDD mandates impact investors focus on achieving net positivity in both individual and aggregate investments. The BIII defines net-positivity as: "*… the totality of all relevant, verifiable effects — intended and unintended, direct and indirect, short-term and long-term — is positive, can be ethically justified and, if possible, does not contain any significant, insufficiently managed negative effects on external stakeholders or the environment.*" This definition emphasizes that IDD ensures societal benefits on a broader holistic level and meanwhile aims at avoiding negative externalities. Moreover, maintaining net-positivity is crucial in mitigating risks of greenwashing and impact washing. Greenwashing involves potential investees exaggerating or falsely claiming positive social or environmental impacts, while impact washing occurs when fund managers or bond issuers inaccurately represent their positive societal impact. These risks may arise both intentionally and due to inadequate impact measurement. Assessing net-positivity over the long term is a key strategy for impact investors to reduce such risks. One such method is the Input-Output-Outcome-Impact [IOOI] approach, which many German impact investors already use. However, it is important to note that certain ESG-related negative impacts, such as human rights violations, cannot be compensated by other positive societal impacts. These are absolute negatives that require direct action and cannot be offset within the net-positivity framework. In the context of the new SFDR regulation, some impact investors are thus required to explore Principle Adverse Impacts [PAIs], which measure negative environmental and social impacts along specific indicators. In addition, fund managers pursuing sustainability objectives have the option of setting up an SFDR fund under Article 9, which comes with a number of requirements, e.g., demonstrating CO2 emission reduction targets.

IDD Principle 5
Impact assessment:
IDD aligns with the type of capital invested, the development phase, and the impact sector of a potential investment.

First, IDD methods, criteria, and processes can differ depending on the asset class. While on a fundamental point, impact investors assess impact in terms of net-positivity equally, different types of impact investors may, for example, have different impact expectations and impact risk profiles corresponding to the different forms of capital invested. Recognizing these variations is crucial for developing more refined IDD processes that accurately reflect the peculiarities associated with each type of capital in impact investment. This aspect is particularly relevant because the strategies for exiting investments also differ according to the type of capital, which, in turn, influences the IDD process [see IDD Principle 8]. Additionally, in the realm of impact venture capital, investments typically occur in multiple rounds. In such scenarios, IDD is not static: It is updated with each subsequent investment round to incorporate the evolving impact and experiences gained from the impact model's implementation. These continual updates ensure that IDD remains relevant and effective in assessing and guiding impact investments through their lifecycle.

Second, IDD procedures are carefully calibrated to account for the different maturity levels and development contexts of both investors and investment recipients, and to ensure the adaptability as well as responsiveness of investment strategies. For investments in early development stages, the focus often lies on narrative descriptions of their impact model, given the lack of extensive data. In contrast, more mature investments are expected to utilize quantitative impact measurement and management approaches. This differentiation is recognized in several international IDD frameworks, such as the ABC of Impact model.

Third, the IDD's content and parameters are tailored precisely to the unique challenges, opportunities, standards, and dynamics inherent in each respective impact sector. This customization is evident in the use of sector-specific impact KPIs and milestones, as well as the employment of various existing impact measurement and management tools, such as the ABC of Impact, IRIS+, and the Five Dimensions of Impact. The distinction between the individual impact areas is similar to the differences in the types of capital and the maturity levels of potential investments. As a result, IDD often requires the development of specialized interview guidelines, questionnaires, or quantitative frameworks that are specifically modified to effectively assess impact in different sectors. Emerging approaches suggest that Artificial Intelligence [AI] solutions may play a significant role in the future by aiding in the derivation of specific KPIs and measurement methods for impact. For impact investors concentrating on particular impact areas, it is crucial to develop or adopt reliable, sector-specific tools. These tools not only facilitate standardization and comparability within individual investments but also across the broader portfolios of impact investors. This sector-specific approach ensures that impact measurement is both accurate and relevant to each sector's unique contexts, enhancing impact investing practice's effectiveness and credibility.

The **"IMMPACT maturity model"** offers impact start-ups and impact investors a structured approach to assess and manage impact in different phases of organizational development, covering everything from early-stage start-ups that rely on qualitative narratives to more established companies with quantitative metrics. It also ensures that IDD can take place together and on an equal footing, as the stakeholders involved have a shared understanding of impact, adapted to the start-up phase. The model was developed in cooperation with the Bertelsmann Stiftung, PHINEO, the BIII, and Social Entrepreneurship Network Germany [SEND].

IDD Principle 6
Time frame:
IDD has a long-term orientation.

IDD necessitates a strategic focus extending beyond immediate outputs, encompassing a sustained commitment to the enduring nature of investments and the persistent, evolving impact on social and environmental spheres for all stakeholders involved. This approach applies to both the impact of individual investments as well as the collective impact of an investor's entire portfolio. Consequently, asset allocators often expect impact investors to demonstrate and validate their long-term impact achievements. A long-term orientation in IDD processes not only secures an investment organization's stability, but also potentially enhances its leverage in other capital market operations. Moreover, even though an impact investment might be short-term in duration, IDD assures that it contributes to achieving overarching long-term impact goals. This approach is also reflected in the formulation of impact KPIs and milestones within IDD, which are designed with a long-term perspective. This ensures that the investments contribute enduring value and align with broader, sustainable goals, thereby reinforcing impact investing strategies' effectiveness and credibility. The long-term perspective is therefore critical to realizing impact investments' transformative potential.

IDD Principle 7
Impact risks:
IDD explores potential impact risks and their potential consequences.

In impact investing, impact risk refers to the possibility of actual outcomes deviating from the intended impact goals, both presently and in the future. IDD systematically addresses this by evaluating various risk types, such as external risks or risks associated with stakeholder participation. Crucially, investors use IDD to examine how these risks might influence the specific impact of an individual investment and the potential ripple effects on their entire portfolio. With this analysis, they then rank the risks based on their possible consequences. Further into the IDD process, investors focus on strategies to either avoid or minimize these identified risks. For example, this may involve enhancing data collection efforts to better inform decision-making. A notable framework that incorporates impact risk assessment is the "Five Dimensions of Impact" developed by Impact Frontiers. Beyond assessing impact risks, IDD also encompasses the evaluation of potential ESG risks associated with investments. This dual approach ensures a comprehensive risk assessment, aligning investments with both impact objectives and ESG criteria.

IDD Principle 8
Exit planning:
IDD involves meticulous planning of possible exit strategies.

In the IDD context, it is essential that investors explore possible responsible exit strategies to ensure their investments have a lasting positive impact. Integral to this process are the principles of long-term orientation and impact risk assessment, as highlighted in IDD Principle 6 and IDD Principle 7. These principles guide investors to plan exit strategies in such a way as to not only meet immediate financial goals but to also support an investment's sustainable impact post-exit. IDD's focus lies on the planning of a seamless transition from investor involvement to independent sustainability, ensuring that impact goals are not compromised. Therefore, investors craft exit strategies to align with impact investing's overarching aims, seeking balance between impactful outcomes and financial returns. Furthermore, exit strategies vary across different types of impact investments. In capital markets, for instance, investors often execute exits through strategies like divestment, whereas direct venture capital investments in startups involve distinct considerations.

IDD Principle 9
Impact management:
IDD plans impact management after the initial IDD process.

IDD plans a systematic and ongoing dialogue between investors and their investments, establishing dynamic impact management. This approach strengthens accountability, fosters adaptive learning, and amplifies the continuous social and environmental impact. Within IDD, a clear framework determines when and how investors evaluate impact milestones through feedback loops. Additionally, this principle encompasses the practice of revisiting IDD processes in scenarios involving successive funding rounds by the same investors. Such iterative processes are crucial in mitigating future risks, such as mission drift, by reducing information asymmetries. Regular impact evaluations and stakeholder feedback are integral to this strategy, enhancing investors' abilities to respond and adapt effectively. This ensures that investments stay attuned to both local requirements and overall impact objectives.

IDD Principle 10
Transparency:
IDD findings are communicated with utmost transparency.

The results and insights from IDD are made transparent and effectively communicated to all relevant stakeholders in a certain way, fostering a culture of openness, trust, and collaborative engagement within the impact investment ecosystem. This transparency is vital for investors, especially at the aggregate portfolio level, to clearly demonstrate their impact. Although this does not mean that investors need transparently communicate every single IDD element, sharing the outcomes of individual IDD assessments with potential investment recipients, whether positive or negative, can increase the future impact potential of projects. Beyond individual investments, it is beneficial for the broader impact investing field if investors openly discuss their IDD methodologies. This exchange of experiences and practices can improve IDD processes across the market, leading to more informed decision-making and, ultimately, heightened social and environmental impact. By openly sharing these elements, impact investors also hold themselves accountable to various stakeholders, including investment recipients, their own funders, and the wider community. This accountability fosters trust and credibility.

CONCLUSION AND OUTLOOK

The IDD Principles provide a comprehensive framework for conducting thorough and effective IDD. Tailored to encompass a variety of impact investment types, these principles guide investors in establishing robust impact assessments, planning effective impact management, and communicating IDD outcomes. Their potential integration into the strategies of diverse impact investors aims to standardize high-quality IDD practices across the field. The IDD principles should encourage future projects and serve as a starting point for further elaboration of the IDD process in certain asset classes.

Furthermore, by facilitating a shift towards impact-oriented investment strategies among traditional investors, they contribute to the broader goal of driving tangible, real-world change.

Finally, it is essential to recognize that these principles are dynamic. A commitment to their continuous improvement and adaptation in response to evolving global challenges and market dynamics is crucial. Such an approach ensures their ongoing relevance and effectiveness in the fluid landscape of impact investing, keeping pace with changing needs and opportunities.

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www.immpact.guide

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